

# GUIDANCE ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES ACCOUNT



# STATE OF IOWA

CREDIT UNION DIVISION  
DEPARTMENT OF COMMERCE



## STATE OF IOWA

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THOMAS J. VILSACK, GOVERNOR  
SALLY J. PEDERSON, LT. GOVERNOR

IOWA DEPARTMENT OF COMMERCE  
CREDIT UNION DIVISION  
JAMES E. FORNEY  
SUPERINTENDENT

### MEMORANDUM

FROM: James Forney, Superintendent of Credit Unions

TO: Chairman, Board of Directors  
C.E.O./Manager  
Iowa State-Chartered Credit Union

Date: January 8, 2003

SUBJECT: Guidance on the Allowance for Loan & Lease Losses

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With the passage of the Credit Union Membership Access Act (CUMAA), all federally insured credit unions must conform to Generally Accepted Accounting Principles (GAAP) when reporting the allowance for loan and lease losses account on the 5300 Call Report [NCUA Rules and Regulations Part 702.402]. NCUA Letter to Credit Unions No. 9, issued June 2002, included an Interruptive Ruling and Policy Statement (IRPS) No. 02-3 regarding the change in estimating this account. The NCUA Letter to Credit Unions and the attached IRPS are available at NCUA's web site [www.ncua.gov](http://www.ncua.gov) by accessing the reference information. This enclosure summarizes the Division's guidance on this issue and is also on the Division's web site [www.iacudiv.state.ia.us](http://www.iacudiv.state.ia.us).

Each credit union is to develop a reasonable and consistently applied methodology for determining and maintaining the Allowance for Loan and Lease Losses (ALLL) Account. The following guidance provides information that should be considered in developing a methodology and the responsibility of credit union officials.

Iowa state-chartered credit unions should have their methodology, policies, estimation processes and validation procedures implemented so the ALLL account is properly reported on the March 31 2003 Call Report. Credit unions that fail to develop an adequate ALLL account may expect to be cited for non-compliance beginning with examination effective dates of March 31 2003 and later.

If you have any questions regarding establishing or maintaining an ALLL Account in accordance with GAAP, I encourage you to contact your accounting professional or assigned Division examiner. Your examiner will be reviewing the methodologies and policies during examinations from this time forward.

# Guidance: Allowance for Loan and Lease Losses Account

## Table of Contents

<b><u>Memorandum from the Superintendent</u></b>	<b><u>i</u></b>
<b><u>Table of Contents</u></b>	<b><u>ii</u></b>
<b><u>Background</u></b>	<b><u>1</u></b>
<b><u>Establishing a Methodology</u></b>	<b><u>1</u></b>
<b><u>The Allowance Account Under FAS 5</u></b>	<b><u>2</u></b>
<u>Historical Analysis</u>	2
<u>Migration Analysis</u>	3
<u>Loss Adjustment Factors</u>	3
<b><u>The Allowance Account Under FAS 114</u></b>	<b><u>4</u></b>
<u>Member Business Loans</u>	4
<b><u>Management's Responsibility for the Allowance</u></b>	<b><u>4</u></b>
<u>Board of Directors and C.E.O. Responsibilities</u>	4
<u>Validation Process</u>	5
<b><u>Regulatory Reporting and Accounting Requirements</u></b>	<b><u>6</u></b>
<b><u>Changes in the Balance of the Allowance</u></b>	<b><u>6</u></b>
<b><u>Examiners' Review of the Credit Union's Process</u></b>	<b><u>6</u></b>
<b><u>Conclusion</u></b>	<b><u>7</u></b>
<b><u>Glossary of Terms</u></b>	<b><u>8</u></b>
<u>Appendix A</u>	9
<u>Appendix B</u>	10
<u>Appendix C</u>	11

## Guidance on Allowance for Loan and Lease Losses

### **BACKGROUND**

The National Credit Union Administration published Interpretive Ruling and Policy Statement (IRPS) 02-3 on May 29, 2002 regarding the Allowance for Loan and Lease Losses Account (Allowance). The following information provides guidance based on IRPS 02-3 for establishing and maintaining the Allowance, one of the most important items affecting credit unions. The Allowance should result in a fair presentation of financial statements in conformity with generally accepted accounting principles (GAAP). Because of the importance of this issue, the Division believes credit unions must have clear and consistent guidelines to follow. This Guidance applies to all credit unions regardless of size and complexity.

The Allowance is a valuation reserve established and maintained by charges against the credit union's operating income. As a valuation reserve, it is an estimate of non-collectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.

### **ESTABLISHING A METHODOLOGY**

Credit unions must establish an Allowance because there is credit risk in all loan and lease portfolios. The Allowance exists to cover the loan losses that occur in the loan portfolio of every credit union. As such, adequate management of the Allowance is an integral part of a credit union's credit risk management process. **The Allowance is not a cushion against possible future losses.** Other reserve accounts provide this protection.

Every credit union must have a program to establish and regularly review the adequacy of its Allowance. The Allowance must be maintained at a level that is adequate to absorb all estimated inherent losses in the loan and lease portfolio as of its evaluation date. A credit union that fails to maintain an adequate Allowance is operating in an unsafe and unsound manner.

Statement of Financial Accounting Standard No. 5 (FAS 5) will apply to most credit unions. This requires that credit unions pool loans into categories with similar loan characteristics. Loss factors applied to these pools may include historical experience adjusted for current conditions mentioned below.

Statement of Financial Accounting Standard No. 114 (FAS 114) provides requirements for large balance loans that should be evaluated for impairment individually. The use of FAS 114 should be rare for most credit unions.

Because no single approach has been determined to be the best, or appropriate, for all credit unions, the Division does not require that credit unions use a specific method to

determine loss experience. The method a credit union uses will depend to a large degree upon the capabilities of its information systems and the size and complexity of the loan and lease portfolio. Acceptable methods range from a simple average of the credit union's loss experience over a period of time, to more complex "migration" analysis techniques.

In principle, the goal of any allowance methodology should be to provide for unconfirmed losses that probably exist as of the evaluation date. How that is accomplished, including the analysis time frames used will depend upon the characteristics of the portfolio and the particular methodology.

## **THE ALLOWANCE ACCOUNT UNDER FAS 5**

Financial Accounting Standard 5 requires that a loss be recognized when it is probable and can be reasonably estimated. FAS 5 allows credit unions to segment or pool loans with like risk characteristics together and then apply a loss factor to the pool to estimate the Allowance.

Smaller asset size credit unions will probably use broad categories such as secured and unsecured. This type of approach is not acceptable unless the credit union offers only a narrow range of loan products, such as only consumer loans. Larger credit unions may use loan types or product line segments based on risk characteristics to pool their loan portfolios. An example of this is different paper grades for risk based lending. The credit union must maintain documentation that supports loans in each category having similar characteristics. Some examples of this documentation are:

1. Loan trial balance by risk or loan types
2. Management reports about the mix of loans in the portfolio
3. Delinquency and non-accrual reports
4. Summary presentation of internal/ external loan grading system

The credit union staff must then apply a loan loss factor to each pool and add these together to determine the estimate for the Allowance for FAS 5 impairment.

### **Historical Analysis**

Loss factors may reflect historical loan loss experience. Credit unions should also adjust this factor for current environmental factors. If a credit union does not have a loss experience of its own, it may be appropriate to reference the loss experience of another credit union provided the credit union demonstrates that the attributes of the loans in its portfolio are similar to the loans of the credit union providing the loss experience.

There is no fixed, historical period of time that should be analyzed by credit unions to determine average historical loss experience. During periods of economic stability in the credit union's markets, a relatively long period of time (e.g., five years) may be appropriate. However, during periods of significant economic expansion or contraction, the credit union may appropriately shorten the historical time period considered in order to more accurately estimate the credit union's inherent losses in the current economic climate. Alternatively, the credit union's analysis may weigh recent experience more heavily. However, due to the instability of small asset size credit union losses, the historical factor should reflect more than 12 months of loss experience.

## **Migration Analysis**

Migration analysis requires a more complex system, than historical analysis. Smaller credit unions may not find it beneficial to use this methodology. Migration analysis techniques, which vary widely between credit unions, are usually and most appropriately applied to pools of past due and/or classified loans. The past due and/or classified statuses of these loans are indicative of the fact that a loss event may or will likely occur.

The most basic forms of migration analysis focus on the classification history of a fixed population of loans that are ultimately charged off. More sophisticated forms of migration analysis track the loss experience on a rolling population of loans over a period of several years and involve the collection and analysis of a very large volume of historical data. Some of the most sophisticated analyses may factor in differences in underwriting standards between different "vintages" of loans, the geographic and demographic attributes of the loans, or the relative seasoning of the loans (e.g., variations in loss experience between auto loans that are less than one year old compared to more seasoned auto loans).

Like the historical average approach, the purpose of a migration analysis is simply to determine, based on the credit union's experience over a historical analysis period, what rate of loss the credit union has incurred on similarly past due loans. Generally speaking, if the migration analysis is being done on a fixed pool of loans, the analysis time frame should cover the resolution of all loans in the pool (i.e., the time period over which the loans are either paid off, returned to performing status, or charged off). If it is a rolling analysis, the analysis time frame typically covers a much longer period.

A credit union may also segment or pool delinquent loans separately. Loss factors for these pools should incorporate migration analysis on delinquent loans and current conditions. The credit union then must compute a loss factor for non-delinquent loan pools using historical charge off information that does not include delinquent loans. Some instances of these types of losses include unforeseen bankruptcies or voluntary repossessions without missed payments.

## **Loss Adjustment Factors**

Estimated impairment should reflect all significant factors that affect the ability to collect the loans and leases as of the evaluation date. While either historical loss experience or migration analysis may provide a reasonable starting point, it is not, by itself, a sufficient basis to determine an adequate level. Management should also consider any factors that are likely to cause estimated losses to differ from historical loss experience or migration analysis, including but not limited to:

- Changes in lending policies and procedures, including underwriting, collection, charge-off, and recovery practices.
- Changes in local economic or business conditions.
- Changes in the volume or type of credit extended.
- Changes in the experience, ability, and depth of lending personnel.
- Changes in the volume or severity of past due, restructured, or classified loans.
- Changes in the quality of a credit union's loan review system or the degree of oversight by the board of directors.
- The existence of, or changes in the level of, any concentrations of credit.

## **THE ALLOWANCE ACCOUNT UNDER FAS 114**

Financial Accounting Standard 114 establishes guidance on impaired large balance loans, which do not fit into a pool. Impairment under this statement should be very rare. NCUA's Interpretive Ruling and Policy Statement 02-3 uses an example of a \$10 million loan. If these loans are determined to be impaired, the value of collateral must be evaluated by one of the following methods:

1. Present value of future cash flows
2. Fair value of the collateral
3. Observable market price

The impairment of a loan reflects a judgment about the risks of default and loss associated with the loan. Loans are impaired when existing facts, conditions, and values suggest it is probable that the credit union will not collect some or all of its loan balance. The portion of the Allowance account for loans analyzed individually must be sufficient to cover the impairment present as of the evaluation date.

The portion of the Allowance for all individually analyzed loans must be based on a reasonable and well-documented estimate of the amount of the loss involved. Credit unions must document the rationale and justification for individually impaired loans that are provided for at a rate that is above or below the historical loss rate for similar loans. Decisions to diverge from the credit union's historical experience for loans must be clearly supported by the nature of the collateral or other circumstances that distinguish the loan from similarly impaired loans. All loans individually impaired that are included in a pool must be subtracted to avoid double counting.

If you have any loan products that fall under FAS 114, you may refer to Interpretive Ruling and Policy Statement 02-3 in the June 2002 NCUA Letter to Credit Unions No. 9. A copy is available at [www.ncua.gov](http://www.ncua.gov) under the publications menu or by contacting the NCUA Region V office. These rules are more cumbersome than the requirements of FAS 5.

### **Member Business Loans**

Member business loans must still be evaluated following the provisions of NCUA Rules and Regulations Part 723, Member Business Loans. This regulation requires that credit unions use substandard (10%), doubtful (50%), and loss (100%) categories to classify their member business loans.

## **MANAGEMENT'S RESPONSIBILITY FOR THE ALLOWANCE**

### **Board of Directors and C.E.O. Responsibilities**

Credit union management must evaluate the adequacy of the Allowance prior to the distribution or posting of any dividends. The board of directors must be provided a summary or consolidation of the Allowance balance. The summary should include the following information:

1. The estimated probable loss incurred in each category
2. Aggregate loss estimate using the credit unions methodology
3. Current balance of ALLL
4. Amount of ALLL adjustment (if needed)
5. Sub-schedules that support the analysis

Examples containing this information are provided in Appendix A, B and C. Example A is the most complex example and breaks down loans according to paper grades and includes additional pools for delinquent credit cards using migration analysis. Example B is the least complex and should only be used by credit unions with few loan products. Example C includes segments for different loan types.

After reviewing the summary information, the board must approve any adjustment to the account.

Regulatory reports and other financial statements must accurately reflect the operating results and financial condition of the credit union for the reporting period. A significant misstated Allowance can violate Iowa Administrative Code 189 – 18.3(1) and 18.4(5), and NCUA Rules and Regulations Part 702.402.

The credit union must document its evaluation process sufficiently to establish that the methods used and the factors considered by the credit union provide a satisfactory basis for determining an adequate level for the Allowance. At a minimum, the credit union must document the basis for allocations of individually analyzed loans and for either the historical loss percentages or the migration analysis used for the portfolio (including any subjective adjustments for current conditions). If large or unusual allocations are made to the Allowance, the credit union must be able to document that the need for the allocation arose in the current period and did not result from inadequate allocations in one or more prior periods.

Documentation complexity depends on the complexity of the credit union's loan portfolio. Credit unions with consumer loans and mortgages may use simplified documentation such as spreadsheets, checklists, and other summary documents.

### **Validation Process**

To ensure the Allowance process is validated, the board must establish internal control policies. The policies should take into consideration the credit union's size and the complexity of the loan portfolio. The policies must incorporate procedures for a review of the Allowance methodology. Someone who is not involved in estimating the appropriate Allowance, such as the Audit Committee, must perform the review. This review shall be performed annually to ensure that the methodology and application are effective.

The following list provides examples of validation procedures. The list, however, is not meant to be all-inclusive:

1. Reviewing trends in the loan portfolio, such as loan volume, delinquency, concentrations, and restructurings
2. Reviewing previous charge off and recovery histories, including evaluating the timeliness of entries
3. Reviewing source documents and underlying assumptions to ensure the methodology results in reasonable estimates
4. Evaluating appraisal processes of underlying collateral to ensure appraisals closely resemble sales prices.

## **REGULATORY REPORTING AND ACCOUNTING REQUIREMENTS**

The credit union must charge off loan and lease losses in the period when the loans, or portions of loans, are deemed a non-earning asset. If the examiner determines the Allowance to be significantly misstated, the credit union must make the necessary adjustments in the quarter the determination is made. If it is clear that significant losses or allocations to the Allowance should have been recognized during a prior period, the Call report for that period must be amended and re-filed.

## **CHANGES IN THE BALANCE OF THE ALLOWANCE**

Adjustments to the Allowance resulting from the credit union's evaluation of its adequacy must be made through charges or credits to the Provision for Loan and Lease Losses Account in the Income/Expense Statement. All charge-offs must be applied directly to the Allowance, and any recoveries on loans or leases previously charged off must be credited to the Allowance. Under no circumstances can loan or lease losses be charged directly to the undivided earnings or regular reserve accounts. **The availability of credit union income shall not be a factor in determining an appropriate level for the Allowance.**

If a credit union finds the Allowance account to be materially overstated after a methodology is established, the excess amount shall be credited to the provision for loan and lease losses (PLL) account of the Expense Statement.

*For the initial evaluation and determination of the adequacy of the Allowance for compliance with GAAP, IRPS 02-3 and this Guidance, any amount credited back to the PLL account should not be considered available to pay dividends or to offset usual operating expenses of this current fiscal year. The reversion of funds through the PLL account should be available at yearend for transfer to the credit union's undivided earnings account. A credit union that initially credits excess funds from the Allowance account to the PLL account must inform their assigned Division examiner-in-charge of the amount transferred during the month in which the transfer occurs.*

The Allowance can never have a debit balance. If losses charged off exceed the amount of the Allowance, a provision sufficient to restore the Allowance to an adequate level must be charged to expenses immediately. A credit union must not increase the Allowance by transfers from the "Undivided earnings " account or appropriations thereof.

## **EXAMINERS' REVIEW OF THE CREDIT UNION'S PROCESS**

While credit unions are responsible for determining an adequate Allowance and adopting a reasonable methodology for doing so, the Division is responsible for reviewing the credit union's Allowance evaluation process and testing the adequacy of the Allowance balance. Examiners should accept management's estimates of an adequate level for the Allowance if the following conditions are satisfied:

1. The credit union has effective policies and procedures for their Allowance methodology and the maintenance of appropriate Allowance adjustments;
2. The credit union is charging off recognized losses in a timely manner;

3. The methodology, loan grading systems, and other items used to support the Allowance estimate are documented;
4. The board of directors are provided an Allowance summary and approve any adjustments;
5. The credit union has established an acceptable Allowance evaluation process that analyzes in a reasonable manner all significant factors that affect the collectibility of the portfolio; and
6. The credit union has validated the allowance account at least annually.

However, if the credit union's Allowance evaluation process is deficient or is based on the results of an unreliable review system, the examiner will have to prepare an estimate of the amount of an appropriate Allowance, based on available information. The examiner's estimate will be based on an analysis of the credit union's portfolio using a method that may produce results that tend to be conservative.

Any significant deficiencies in the credit union's process for determining the level of the Allowance will be clearly detailed in the Examiner's Findings or Document of Resolution contained in the Management Report. Report comments should emphasize that the credit union's management is responsible for implementing an effective internal process that will ensure maintenance of an adequate Allowance. The report will also document the agreed upon corrective action necessary to improve the credit union's process.

## **CONCLUSION**

Every credit union must have a program to establish and regularly review the adequacy of its allowance. The allowance must be maintained at a level that is adequate to cover losses in the loan and lease portfolio that are probable and estimable on the date of the evaluation. This requires management to establish appropriate processes to recognize problem loans in a timely manner and a sound analytical process for estimating the amount of inherent loss in its loan and lease portfolio.

## **GLOSSARY OF TERMS**

**Environmental Factors** – Factors affecting the collectibility of loans that are outside of a credit union's control. Some examples include sponsor layoffs, local economic conditions, and political factors.

**Impairment** – A loan is impaired when it is probable that a creditor (credit union) will be unable to collect all amounts due, including principal and interest, according to the contractual terms and schedules of the loan agreement.

**Inherent loss** - An inherent loss is an unconfirmed loss that probably exists based on information available when the evaluation is made. The amount of the loss must be subject to reasonable estimation. It should be based on the credit union's current plans for collection and the realizable value of any collateral. If it is not probable that the loss exists, or if the amount of the loss cannot be reasonably estimated, no adjustment should be made to the Allowance.

**Loan Segmentation** – Presentation of information about certain parts of a loan portfolio, in contrast to information about the entire portfolio.

**Loss Factors** – Internal or external information that provides a reasonable basis for estimating loan impairment on a pool basis, consistently applied.

**Migration Analysis** - A method to determine the adequacy of valuation allowances by tracking movements (or migration) of a classified asset to a worse classification in order to estimate a loss percentage likely to be incurred from different categories of assets within the current portfolio.

**Probable** – Higher level of likelihood than “more likely than not.”

**Reasonably Estimated** – An educated guess as to the amount of impairment in a loan segment or portfolio. Financial Accounting Standards Board Interpretation No. 14, states it is not necessary to specify a single amount. The ability to estimate a range of loss is sufficient to satisfy this condition.

**Significant misstatement** - A significant misstatement results in a change in the Statement of Financial Condition or Income/Expense Statement that would cause the examiner to ask credit union management to adjust the call report to provide more accurate information for financial statement analysis.

**Validation** – A process used to determine if loss estimation methods closely resemble actual subsequent charge-offs. If there are significant differences between the estimation and actual charge-offs, the method should be adjusted. This should be done at least annually.

## Appendix A

ALLOWANCE CALCULATION – COMPLEX EXAMPLE OF POOLING BY RISK CATEGORIES					
CATEGORY	LOAN BALANCE	LAST 12 MONTHS LOSSES	*CHARGE OFF %	ADJUSTED ESTIMATE**	REQUIRED ALLL BALANCE
AUTO RISK A	\$42,500,000	\$12,000	0.028%	0.028%	\$11,900
AUTO RISK B	\$13,400,000	\$49,000	0.366%	0.400%	\$53,600
AUTO RISK C	\$7,320,000	\$142,000	1.940%	2.000%	\$146,400
AUTO RISK D	\$2,980,000	\$93,000	3.121%	4.000%	\$119,200
OTHER SECURED	\$12,000,000	\$87,000	0.725%	1.000%	\$120,000
UNSECURED LOANS	\$45,000,000	\$450,000	1.000%	1.000%	\$450,000
VISA RISK LEVEL 1	\$9,200,000	\$61,000	0.663%	0.663%	\$60,996
VISA RISK LEVEL 2	\$4,980,000	\$79,000	1.586%	1.586%	\$78,983
VISA RISK LEVEL 3	\$2,600,000	\$86,000	3.308%	3.308%	\$86,008
VISA RISK LEVEL 4	\$120,000	\$92,000	76.667%	80.000%	\$96,000
ALL OTHER VISA	\$33,000,000	\$125,000	0.379%	0.500%	\$165,000
REAL ESTATE	\$72,000,000	\$0	0.000%	0.500%	\$360
<b>TOTAL:</b>	<b>\$245,100,000</b>	<b>\$1,276,000</b>			<b>\$1,388,447</b>
AUTO RISK A: New and used autos with credit scoring 730+					
AUTO RISK B: New and used autos with credit scoring 729 – 680					
AUTO RISK C: New and used autos with credit scoring 679 – 600					
AUTO RISK D: New and used autos with credit scoring below 599					
VISA RISK LEVEL 1: Delinquent Visa > 60 days, recent payments					
VISA RISK LEVEL 2: Delinquent Visa > 60 days slow payments					
VISA RISK LEVEL 3: Delinquent Visa > 60 days inconsistent payments; legal action pending					
VISA RISK LEVEL 4: Delinquent Visa > 60 days, unlikely collection, bankruptcy; pending charge-off					
*See attached for other observable data that can be used					
** Adjusted Estimate rounded until conditions change warranting re-assessment.					

## Appendix B

ALLOWANCE CALCULATION - EXAMPLE OF POOLING USING BROAD CATEGORIES						
CATEGORY	LOAN BALANCE	LAST 12 MONTHS LOSSES	LOSSES IN PREV. 12 MONTHS	AVERAGE ANNUAL LOSS	CHARGE OFF %	REQUIRED ALLL BALANCE
Unsecured	\$100,000	\$2,000	\$500	\$1,250	1.25%	\$1,250
Secured	\$900,000	\$4,000	\$900	\$2,450	0.27%	\$2,450
	\$1,000,000					\$3,700

## Appendix C

ALLOWANCE CALCULATION - EXAMPLE OF POOLING BY LOAN TYPES					
CATEGORY	LOAN BALANCE	LAST 12 MO LOSSES	CHARGE OFF %	ADJUSTED ESTIMATE **	REQUIRED ALLL BALANCE
Unsecured Credit Card	\$1,471,496	\$22,000	1.50%	1.50%	\$22,000
Other Unsecured	\$420,719	\$5,000	1.19%	1.19%	\$5,000
New Vehicle	\$1,282,785	\$5,000	0.39%	0.39%	\$5,000
Used Vehicle	\$3,031,596	\$17,000	0.56%	0.56%	\$17,000
Real Estate	\$2,004,085	\$0	0.00%	0.50%	\$10,020
Other Secured	\$87,048	\$500	0.57%	0.57%	\$500
	\$8,297,729				\$59,520
**Adjusted Estimate rounded until conditions change warranting re-assessment.					